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Regulation LL and Recent Developments Under the Federal Reserve Board's Control Rules: Issues for All Holding Companies and Investors

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Introduction

The federal banking laws require that appropriate regulatory approvals must be obtained before an individual or company may take actions to directly or indirectly "control" a bank or savings association.[1] These rules impact both bank and thrift holding companies as well as their investors. Recent actions taken by the Federal Reserve Board and its staff (the "Board") significantly impact the application of these rules:

(1) for investors in thrift institutions, by means of the Board's adoption of Regulation LL in new Part 238 of Title 12 of the Code of Federal Regulations, as described below; and

(2) for all minority investors in banking organizations, by means of the Board's increased focus on and scrutiny of minority stock investments below the 10% threshold under Regulations Y[2] and LL.

On August 12, 2011, the Board, in its new role as the regulator of savings and loan holding companies ("SLHCs"), issued an interim final rule establishing Regulation LL ("Interim Final Rule"),[3] which sets forth regulations generally governing SLHCs, as modified from the regulations previously administered by the former Office of Thrift Supervision pursuant to the Home Owners' Loan Act ("HOLA")[4] and other federal statutes. In particular, Regulation LL modifies the regulations previously used by the OTS for purposes of determining when a company or natural person acquires control of a savings association or SLHC under the HOLA or the Change in Bank Control Act (''CBCA'')[5] and includes provisions interpreting the definition of "control" under the HOLA in the same manner as that term is interpreted under the Bank Holding Company Act ("BHCA").[6] Regulation LL also adopts procedures for reviewing control determinations that are identical for SLHCs and bank holding companies ("BHCs"), and conforms the filing requirements under the CBCA for SLHCs to those for BHCs.[7]

In addition to reaffirming its policy that the Board reviews all investors based on all of the facts and circumstances to determine if a controlling influence is present, it appears that the Board's recent actions indicate that it intends to more closely scrutinize voting stock investments in the 5-10% range to determine if control filings are required under the BHCA or HOLA, as applicable (together, the "Holding Company Acts") and their implementing regulations. As the Board settles in to its new role as the regulator of SLHCs and further reviews this area, we believe the Board is likely to propose new regulations or guidance in the near future providing detailed rules and guidance with respect to the application of Regulations Y and LL to minority stock investments. We also believe the anticipated

new Board policy will focus increased regulatory scrutiny on minority stock investments in banking organizations.

Regulation LL

With respect to control determinations under new Regulation LL, the preamble to the Board's Interim Final Rule indicates that the Board intends to "review investments and relationships with SLHCs by companies using the current practices and policies applicable to BHCs to the extent possible."[8]

For these purposes, the preamble further points out that the definition for "control" found in the HOLA is similar to that found in the BHCA, given that both statutes apply a similar three-prong test for determining when a company controls a savings association or bank, respectively.[9] Specifically, a company[10] has control over either a bank or savings association if the company:

1. directly or indirectly or acting in concert with one or more persons, owns, controls, or has the power to vote 25% or more of the voting securities of a company;

2. controls in any manner the election of a majority of the directors[11] of the board; or

3. directly or indirectly exercises a controlling influence over the management or policies of the bank.[12]

This similarity in statutory language has enabled the Board to include in Regulation LL provisions interpreting the definition of control under HOLA in the same manner as that term is interpreted under the BHCA, procedures for reviewing control determination that are identical for SLHCs and BHCs, and filing requirements under the CBCA for SLHCs that are conformed to those applicable for BHCs. As a result of the Board's modification and transfer of the old OTS regulations to new Regulation LL, OTS regulations relating to control determinations and rebuttals under HOLA, including the rebuttable control factors and process set forth in former 12 C.F.R. § 574.4, the certification of ownership in former 12 C.F.R. § 574.5, and the rebuttal agreement in former 12 C.F.R. § 574.100, are not included in Regulation LL. Moreover, the Board's new regulations include a specific definition of "control" similar to the foregoing statutory definition, with certain additional indicators of control provided for by regulation.[13] In addition to the rebuttable presumptions of control set forth in the implementing regulations, the Board's supervision manual for BHCs provides that "there are a number of other circumstances that are indicative of control and may call for further investigation to uncover facts that support a determination of control. Such circumstances include situations where: (i) a company owns at least 10% of each of two banks or at least 5% of each of three or more banks; and (ii) a company owns 5% or more of a bank or bank holding company and has been instrumental in the hiring or firing of one or more persons; establishing policies or places for branches; establishing hours of business; deciding on rates, terms, or acceptance of loans or deposits; following uniform advertising practices or using a common telephone system; or any other respects directing the activities of management or establishing the policies of the bank or company."[14]

In line with the current Board practice of considering potential control relationships for all investors in connection with applications submitted under section 3 of the BHCA, the Board noted in the Interim Final Rule that it intends to review potential control relationships for all investors in connection with applications submitted to the Board under the HOLA.[15] In situations where investors believe no application is required, the Board encourages investors to "consult" with Board staff to determine what type of review is appropriate to confirm that the Board concurs that no filing is necessary under the Holding Company Acts and their implementing regulations. As with OTS practice, and as discussed below, the Board often obtains a series of passivity commitments from investors seeking non-control determinations.

New Board Scrutiny of Minority Stock Investments: 5 – 10% Investments

Minority equity investments in banking organizations are designed not to trigger either of the first two prongs of the statutory definition of control under the Holding Company Acts. However, minority investments often raise questions regarding whether the investor will be able to exercise a controlling influence over the management or policies of a banking organization. In this regard, the Board reviews all investors, including minority investors, based on all of the facts and circumstances to determine if a controlling influence is present for purposes of the Holding Company Acts.

In this regard, a statutory presumption of non-control is afforded to less-than-5% shareholders under the BHCA and is made applicable to SLHCs under Regulation LL.[16] With respect to investments between 5% and 10% of voting stock in banking organizations however, the Board has recently focused increased scrutiny on this category of investments.

In assessing whether an investor has the ability to exercise a controlling influence over a banking organization, the Board is guided by the principle that the Holding Company Acts are intended to ensure that companies that acquire control of banking organizations have the financial and managerial strength, integrity, and competence to exercise that control in a safe and sound manner.[17] By tying control and responsibility together, the Holding Company Acts and their implementing regulations ensure that companies have positive incentives to run a successful banking organization but also bear the costs of their significant involvement in the banking organization's decision-making process, thus protecting taxpayers from imprudent risk taking by companies that control banking organizations.

Through the imposition of so-called passivity commitments, the Board requires minority investors that are unwilling to be subject to the responsibilities associated with controlling a banking organization to limit their influence over the management and policies of the banking organization. This guiding principle can be extended going forward to Board control determinations under the HOLA as well. That is, investors seeking the protection of being free from regulation and oversight as a SLHC under the HOLA would be expected to be limited in their involvement and influence over the management and policies of the SLHC and its subsidiaries.

Passivity commitments are generally tailored to the specific transaction presented to the Board for approval or non-objection. Attached at the end of this article is the standard form of passivity commitments that the Board has in the past generally relied on in making non-control determinations.

Limits on Director Representation

Director representation is relevant to the Board's determination of whether a minority investor is able to exercise a controlling influence over the management or policies of a banking organization.[18] For example, in considering whether several minority investor groups proposing to make parallel less-than-10% investments in Doral Financial Corporation, a BHC, were required to make a control filing under the BHCA, Board staff declined to require such a filing after (1) accepting passivity commitments made by the investors to ensure that the investors would remain passive and would not otherwise have the ability to exercise a controlling influence over the banking organization; and (2) making a determination of non-control upon consideration of all relevant facts and circumstances, including the passivity commitments made by the investors. Under the passivity commitments accepted by the Board in the Doral investment, each less-than-10% investor committed, among other things:

- not to exercise or attempt to exercise a controlling influence over the management or policies of the banking organization;
- not to have or seek to have more than one director representative on the board of the banking organization and its subsidiary;

- not to enter into any banking or non-banking transaction with any of the BHC parties involved or any of their subsidiaries, except as specifically permitted by several carve-outs in the particular commitment;
- not to propose a director or slate of directors in opposition to a nominee or slate of nominees proposed by the management or board of directors of the banking organization;
- not to solicit or participate in soliciting proxies with respect to any matter presented to the shareholders of the banking organization or its subsidiaries, except to the extent that the investor may be deemed to solicit or participate in soliciting proxies through its single board seat;
- not to attempt to influence the dividend policies; loan, credit, or investment decisions or policies; pricing of services; personnel decisions; operations activities, including the location of any offices or branches or their hours of operation, etc.; and
- not to dispose or threaten to dispose of the BHC shares directly or indirectly held by the investor in any manner as a condition of specific action or non-action by the BHC.[19]

The Board has typically required these types of passivity commitments to be made by minority investors seeking to make passive investments in banking organizations.[20] That is, where the Board determines that a control filing under the Holding Company Acts is not necessary, the Board has historically often obtained a series of commitments from investors seeking non-control determinations.[21] Such commitments sought from the investor are extensive and are designed to ensure that the investor's actions going forward with respect to the investment are consistent with those of a passive investor and specifically that the investor will not exercise a controlling influence over the acquiree. These commitments are often referred to as the "Crown X" commitments or "Lincoln" commitments as a result of the letters in which they first appeared.[22] Over the years since the Crown X and Lincoln commitments were first imposed in 1985 and 1986 respectively, the commitments have been modified,[23] however have generally remained as extensive and have continued to be imposed on passive investors.[24] Recent passivity commitments required by the Board of less-than-10% shareholders in banking organizations have included a limit on board representation to one director.[25]

As demonstrated in recent minority investments approved by the Board, consistent with the Board's practice of considering all facts and circumstances of an investment in controlling influence determinations, a less-than-10% investment coupled with a single board seat is not immune from scrutiny with respect to whether the investor can exercise a controlling influence over the management or policies of the banking organization.

The Board's Minority Investment Policy

The Board issued guidance in 2008 that, under limited circumstances, permits certain minority investors with voting interests in banking organizations that range from 10% to 24.9% to have up to two director representatives on the board of a banking organization where certain conditions (including director representation not exceeding 25% of the voting members of the board) are met. Consistent with past practice, the Board is likely to limit board representation for a minority investor with a 5% to 9.9% voting interest to one director, assuming the investor does not otherwise exercise or attempt to exercise a controlling influence over the banking organization. If, however, the Board determines that, through the board representation or by any other means, the minority investor will be able to exercise a controlling interest over the management or policies of the banking organization, then it is expected that no director representative will be permitted unless the investor first makes the requisite control filing under the Holding Company Acts.[26]

Action Plan

- Bank, financial and thrift holding companies should consider reviewing minority investments in their organizations to determine if an investor's level of stock ownership, actions and conduct are consistent with a passive investment, and whether the investment would qualify for a passivity agreement under the relevant control rules, or would the investor be required to make control filings in appropriate circumstances. Non-control determinations made by the Board are generally only based on the facts presented and therefore can no longer be relied upon in the case of changed facts or circumstances. Moreover, while the Board has stated it does not anticipate revisiting ownership structures previously approved by the OTS, it is possible for control issues to surface when an application or request for non-objection is pending before the Board. In appropriate cases, investors may be found to be in violation of the Board's control rules and will be required to take remedial actions; they may also be subject to enforcement action and litigation.
- Similarly, investors should review their current and anticipated stockholdings in banking organizations, as well as their actions and conduct with respect to the banking organizations to determine if they are in compliance with the Board's current rules and policies under the Holding Company Acts and Regulations Y and LL.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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[1] A company proposing to become a BHC or SLHC must apply for the Board's prior approval under Section 3 of the Bank Holding Company Act and Regulation Y or Section 10(e) of the Home Owners' Loan Act and Regulation LL, respectively. The applicant must submit detailed information about the proposed transaction for the Board's consideration, including general background, financial resources, managerial resources, future prospects, convenience and needs of the community, competitive factors and voting trusts and corporate trustees. The applicant must publish a notice in the local newspaper(s), and the Board will publish a notice in the *Federal Register* for public comment. With respect to filings under the CBCA, the Board generally must be given 60 days prior written notice of a proposed acquisition of a controlling ownership interest in a banking organization. A change in bank control notice should include biographical and financial information on the filer(s); details of the proposed acquisition; information on any proposed structural, managerial, or financial changes that would affect the banking organization to be acquired; and other relevant information required by the Board. The primary forms to be completed as a part of a notice are the Interagency Biographical and Financial Report form and the Interagency Notice of Change in Control.

[2] 12 C.F.R. Part 225.

[3] 76 Fed. Reg. 56508 (September 13, 2011).

[4] 12 U.S.C. §§ 1461 *et seq*.

[5] 12 U.S.C. § 1817(j).

[6] 12 U.S.C. §§ 1841 *et seq*.

[7] 76 Fed. Reg. 56508, 56509 (September 13, 2011).

[8] *Id.*

[9] *Id.*

[10] Under the HOLA, a holding company can include a person rather than only legal entities under the BHCA.

[11] For purposes of the HOLA, a "director" is "any director of a corporation or any individual who performs similar functions in respect of any company, including a trustee under a trust." 12 C.F.R. § 238.2(f).

[12] 12 U.S.C. §§ 1841(a)(2) and 1467(a)(2).

[13] *See* 12 C.F.R. §§ 225.2(e) and 238.2(e). Moreover, Regulation Y (for BHCs) and Regulation LL (for SLHCs) set forth a set of rebuttable presumptions of control which, if triggered, requires a filing by the presumed control party to rebut the presumption by explaining why a control filing is not needed. 12 C.F.R. §§ 225.31(d) and 238.21(d).

[14] Section 2090.0.4.2 of the BHC Supervision Manual (July 2010).

[15] 76 Fed. Reg. 56508, 56509 (September 13, 2011).

[16] 12 U.S.C. § 1841(a)(3); 12 C.F.R. §§ 225.31(e) and 238.21(e). The presumption of non-control means just that. The Board does not foreclose the possibility that a less-than-5% shareholder controls a banking organization, however the burden is on the Board to overcome the presumption of non-control.

[17] *See, e.g.*, Section 2090.4.1 of the BHC Supervision Manual.

[18] *See, e.g.*, 2008 Board Policy Statement and Board Letter dated May 1, 1986, to counsel for Lincoln Financial Corporation.

[19] Appendix to Doral Letter, Passivity Commitments.

[20] *See, e.g.*, Goldman Sachs passivity commitments dated March 11, 2011 (approval to retain a 9.8% interest in Avenue Financial Holdings, Inc., holding company for Avenue Bank); *see also* Morgan Stanley passivity commitments dated June 26, 2009 (approval to acquire additional shares in Chinatrust Financial Holding Company Ltd. up to 9.9%).

[21] *See id*.

[22] Letter dated May 28, 1985, to counsel for Crown X, Inc., and Letter dated May 1, 1986, to counsel for Lincoln Financial Corporation.

[23] *E.g.*, the board representation limitations were relaxed in the 2008 Board Policy Statement for 10% to 24.9% minority shareholders.

[24] More recently, the passivity commitments were imposed on Goldman Sachs in March 2011 with respect to its proposal to retain a 9.8% interest in Avenue Financial Holdings, Inc., and on Morgan Stanley in February 2009, with respect to its proposal to acquire additional shares up to 9.9% in Chinatrust Financial Holding Company Ltd.

[25] *See, e.g.,* Board Letter dated July 18, 2007, from the Board's general counsel to B. Robbins Kiessling, Esq. ("Doral Letter"); Board Order dated March 11, 2011 (approval to retain a 9.8% interest in Avenue Financial Holdings, Inc., holding company for Avenue Bank upon acceptance of Goldman Sachs passivity commitments); and Board Order dated June 26, 2009 (approval to acquire additional shares in Chinatrust Financial Holding Company Ltd. up to 9.9% upon acceptance of Morgan Stanley passivity commitments).

[26] *See, e.g.*, the 2008 Board Policy Statement. Controlling influence determinations are based on all the facts and circumstances, regardless of investment level. What may be viewed as permitted acts for investors under the 2008 Board Policy Statement presumes that there are no other indicia of control.

Standard Form of Passivity Commitments Used By the Federal Reserve For Proposed Minority Investment Transactions Involving Banking Organizations

[Acquirer Name], [city, state], and its subsidiaries and affiliates (collectively, "[Acquirer Name]"), will not, without the prior approval of the Board or its staff, directly or indirectly:

1. Exercise or attempt to exercise a controlling influence over the management or policies of [Target] ("[Target]"), [City, State], or any of its subsidiaries;

2. Have or seek to have more than one representative of [Acquirer Name] serve on the board of directors of [Target] or any of its subsidiaries;

3. Permit any representative of the [Acquirer Name] Acquirer Group who serves on the board of directors of [Target] or any of its subsidiaries to serve:

    i. as the chairman of the board of directors of [Target] or any of its subsidiaries;
    ii. as the chairman of any committee of the board of directors of [Target] or any of its subsidiaries;
    iii. as a member of any committee of the board of directors of [Target] or any of its subsidiaries if the [Acquirer Name] Acquirer Group representative occupies more than 25 percent of the seats on the committee;
    iv. as a member of an audit committee of the board of directors of [Target] or any of its subsidiaries;
    v. as a member of any committee of the board of directors of [Target] or any of its subsidiaries that approves or reviews, or establishes policies for the approval or review of, loans or other extensions of credit;
    vi. as a member of any committee of the board of directors of [Target] or any of its subsidiaries if at any time such committee would have decisionmaking authority for policies or actions on managerial matters (other than decisions related to retaining third party consultants or advisers in connection with carrying out committee duties); or
    vii. as a member of any committee of [Target] or any of its subsidiaries if such representative has the authority or practical ability unilaterally to make, or block the making of, policy or other decisions that bind the board, any committee of the board, or management of [Target];

4. Have or seek to have any employee or representative of the [Acquirer Name] serve as an officer, agent, or employee of [Target] or any of its subsidiaries;

5. Take any action that would cause [Target] or any of its subsidiaries to become a subsidiary of [Acquirer Name];

6. Own, control, or hold with power to vote securities that (when aggregated with securities that the officers and directors of the [Acquirer Name] own, control, or hold with power to vote) represent 25 percent or more of any class of voting securities of [Target] or any of its subsidiaries;

7. Own or control equity interests that would result in the combined voting and nonvoting equity interests of the [Acquirer Name] and its officers and directors to equal or exceed 25 percent of the total equity capital of [Target] or any of its subsidiaries, except that, if the [Acquirer Name] and its officers and directors own, hold, or have the power to vote less than 15 percent of the outstanding shares of any classes of voting securities of [Target], [Acquirer Name] and its officers and directors may own or control equity interests greater than 25 percent, but in no case more than 33.3 percent, of the total equity capital of [Target] or any of its subsidiaries;

8. Propose a director or slate of directors in opposition to a nominee or slate of nominees proposed by the management or board of directors of [Target] or any of its subsidiaries;

9. Enter into any agreement with [Target] or any of its subsidiaries that substantially limits the discretion of [Target]'s management over major policies and decisions, including, but not limited to, policies or decisions about employing and compensating executive officers; engaging in new business lines; raising additional debt or equity capital; merging or consolidating with another firm; or acquiring, selling, leasing, transferring, or disposing of material assets, subsidiaries, or other entities;

10. Solicit or participate in soliciting proxies with respect to any matter presented to the shareholders of [Target] or any of its subsidiaries;

11. Dispose or threaten to dispose (explicitly or implicitly) of equity interests of [Target] or any of its subsidiaries in any manner as a condition or inducement of specific action or non-action by [Target] or any of its subsidiaries; or

12. Enter into any other banking or nonbanking transactions with [Target] or any of its subsidiaries, except that the [Acquirer Name] may establish and maintain deposit accounts with [Target], provided that the aggregate balance of all such deposit accounts does not exceed $500,000 and that the accounts are maintained on substantially the same terms as those prevailing for comparable accounts of persons unaffiliated with [Target].

The terms used in these commitments have the same meanings as set forth in the Bank Holding Company Act of 1956, as amended, and the Board's Regulation Y.

Nothing in these commitments releases the [Acquirer Name] from compliance with the Change in Bank Control Act of 1978, as amended, and any regulations thereunder for any subsequent acquisition or increase in the percentage ownership of any class of voting shares of [Target].

[Acquirer Name] understands that these commitments constitute conditions imposed in writing in connection with the Board's findings and decisions related to [Acquirer Name]'s acquisition of up to [__] percent of voting shares of [Target], and, as such, may be enforced in proceedings under applicable law.